SO ORDERED.

SIGNED this 14 day of September, 2004.

Dale L. Somers
Dale L. Somers
UNITED STATES BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In re:	
HORSE TRENDS EQUESTRIAN PARK, INC.,	**CASE NO. 01-20347-7C**
	CHAPTER 7
DEBTOR.	

MEMORANDUM OF DECISION ON OBJECTION

TO PEOPLES BANK'S PROOF OF CLAIM

This matter is before the Court for a decision on Betty Rowley's objection to the claim filed by Peoples Bank. Ms. Rowley appears by counsel Laurence M. Jarvis; Dennis E. Mitchell had also appeared for her at times, but he has since withdrawn. Peoples Bank appears by counsel Bradley R. Finkeldei. The Court has reviewed the relevant materials and heard the arguments of counsel, and is now ready to rule.

Over a number of years, various members of Ms. Rowley's family had obtained loans from Peoples Bank. Debtor Horse Trends Equestrian Park, Inc.[1] ("Horse Trends"), largely or completely owned by the Rowley family, also borrowed money from Peoples. In February 2001, Horse Trends filed a Chapter 11 bankruptcy case that was soon converted to Chapter 7. That June, the Rowleys and Peoples reached a settlement. After the Rowleys fulfilled their payment obligation under the settlement, Peoples filed a proof of claim in the Horse Trends bankruptcy, asserting an unsecured claim of more than $500,000. Ms. Rowley contends that Peoples gave up that claim in the June 2001 settlement. As explained below, the Court concludes that Peoples's claim is no longer enforceable against Horse Trends and must be disallowed.

FACTS

The following description of the facts is drawn from the parties' stipulations, documents submitted by agreement, and other pleadings filed in the Horse Trends bankruptcy case.

Rowley family members (apparently not including Betty) own some or all the interests in Horse Trends, and control the corporation. Peoples provided financing to Horse Trends, secured by the corporation's real property and some relatively minor items of personal property. In 1997, Horse Trends sued a manufacturer and construction company over problems with one or more structures built on the real property, and

[1]Some of the documents before the Court use "Horsetrends" instead of "Horse Trends," but the court file uses the latter and that is what the Court will use.

obtained a judgment sometime before May 2000 ("the Construction Judgment"). The construction problems had caused the real property to be worth less than Horse Trends and Peoples had expected it to be.

Between 1995 and 2000, Horse Trends and various members of the Rowley family, including Betty, obtained loans from Peoples. In December 1999, Peoples sued Horse Trends and many of the Rowleys to collect on their debts. In April 2000, Peoples sued another of the Rowleys to collect on her debt. On May 25, 2000, Peoples settled both these suits, and dismissed them. Among other things, as part of the settlement, Horse Trends gave Peoples a security interest in the Construction Judgment, and agreed that its real property would serve as collateral for all the debts involved in both lawsuits. The settlement also gave Horse Trends about nine months to sell its real property. At the end of that time, Peoples had the right to obtain from escrow and record a quitclaim deed transferring the real property from Horse Trends to the bank.

On the last day for Horse Trends to sell its real property under the settlement agreement, February 15, 2001, Horse Trends filed a Chapter 11 bankruptcy petition. No schedules were filed that day, but the "List of Creditors Holding 20 Largest Unsecured Claims" required by Federal Rule of Bankruptcy Procedure 1007(d) was, although only 18 creditors were reported. Peoples was included on this list as the holder of a disputed claim of over $1.4 million, with no indication that any of its claim was secured. Ms. Rowley was not included on the list. A week later, Peoples filed a motion for stay relief,

describing itself as the holder of a secured claim. The motion also alleged that the debtor had no equity in the bank's collateral, perhaps suggesting that the bank thought it would still have an unsecured claim after liquidating its collateral. When the debtor's schedules were filed a couple of weeks after its petition, Peoples was listed on Schedule D as the holder of three disputed secured claims totaling over $1.4 million, with "0" inserted in the spaces where any unsecured portions of the claims were to be listed. Peoples was not included on Schedule F as the holder of any unsecured nonpriority claim. Ms. Rowley was included on Schedule F, and the amount of her unsecured claim was reported to be $230,000, more than the amounts given for any of the creditors included on the list of the 20 largest unsecured creditors, except Peoples. On its Schedule B, Horse Trends listed as an asset a contingent or unliquidated claim for over $340,000, including no information other than the dollar value of the claim. Shortly after filing its bankruptcy petition, Horse Trends received about $63,000, apparently its final recovery on the Construction Judgment. On the U.S. Trustee's motion, the case was converted to Chapter 7 on March 23, 2001, and the $63,000 was turned over to the Chapter 7 trustee. On May 2, 2001, Horse Trends amended Schedule B to indicate that its contingent or unliquidated claim was a "possible cause of action against Peoples Bank."

In January 2001, Peoples had sued many of the Rowleys, including Betty, to collect debts and foreclose on personal property securing the debts. The Rowleys asserted counterclaims alleging that a former bank officer had forged the signatures of

some of the Rowley family members on some documents and had them notarized. On June 7 that year, the Rowleys and Peoples reached an agreement to settle their disputes. By that time, Peoples had obtained stay relief in the Horse Trends bankruptcy, so it was free to file the deed making it the owner of the real property the corporation had pledged to it, although it had not yet done so. The main thrust of the settlement was for the Rowleys to pay Peoples $590,000 by June 15, and for Peoples to transfer the former Horse Trends real property to an entity called "Equicenter"[2] (presumably owned by the Rowleys). Apparently the Rowleys were not able to get the money by the deadline, so the parties executed another agreement on June 18 that added $4,424 to the amount they had to pay Peoples and gave them until July 16 to do so. This version of the agreement was altered in a few other ways, but the changes in the payment terms were the most significant ones. The later agreement stated that it replaced the June 7 one, so the Court concludes the June 18 agreement controls to the extent they differ.

The dispute the Court must resolve concerns the meaning of certain portions of paragraph 2 of the June 18 settlement:

> On or before July 16, 2001, the Rowleys will pay Peoples the sum of $594,424.00 in cash. . . . At that time all of the Notes which are subject to the [lawsuit Peoples filed in January 2001], and all secured claims in the bankruptcy court will be considered paid in full, and the Notes will be returned marked "paid." At that time, all mortgages, liens and other encumbrances that Peoples has on any

[2]In one document, this entity is called "Equicenter, L.L.C.," and in another, "Equicenter Incorporated." The form of the business is not relevant here, so the Court will simply call it "Equicenter."

> collateral that Horsetrends or the Rowleys have ever pledged to Peoples, will be released. . . .

Of course, other provisions in the agreement have a bearing on the Court's reading of this language. For example, paragraph C declares that "Peoples and the Rowleys desire to settle all outstanding disputes, claims and causes of action between them." Paragraph D provides that Horse Trends is a third-party beneficiary of the settlement. Paragraph 5 states that upon performance of the agreement, each party releases the other party "from any and all liability arising out of any act, omission or transaction that has happened or occurred prior to and including the date of this Agreement." The paragraph then adds, "[Horse Trends], the officers and members of the Board of Directors of [Horse Trends], and all of the Rowleys are represented by legal counsel in this matter or have the right to such representation and are fully aware of their legal rights and obligations as a result of this agreement." Finally, paragraph 9 provides that the agreement "shall be interpreted and governed by the laws of the State of Kansas." Apparently on July 23, rather than July 16, the Rowleys paid Peoples $594,528; the extra amount they paid was presumably interest. Peoples treated this as fulfilling the Rowleys' obligations under the settlement. It marked "paid in full" on all the notes identified in the settlement and returned them to the Rowleys, along with various security agreements and other loan documents. Peoples also filed releases of the various mortgages that Horse Trends had given it on the corporation's real property. Peoples then transferred the real property to Equicenter as called for by the settlement.

Shortly after the Rowleys made the payment, Peoples filed a proof of claim in the Horse Trends bankruptcy case, the only one it has filed. In the proof of claim, Peoples described the settlement with the Rowleys as a sale of its collateral, showed the payment as a credit against the amount Horse Trends owed it when the bankruptcy case was filed, and asserted an unsecured claim for the difference, $527,571.50. Peoples attached copies of an April 1999 promissory note in which Horse Trends promised to pay Peoples about $807,000, and a January 1999 promissory note and modification agreement by which Horse Trends agreed its real property would secure Renae Rowley's promise to pay Peoples $125,000. Both notes appear to qualify as negotiable instruments under Article 3 of the Kansas version of the Uniform Commercial Code.[3] The notes and modification agreement were among those Peoples marked "paid in full" and returned to the Rowleys in connection with the settlement. Meanwhile, on July 19, 2001, Betty Rowley had filed a proof of claim asserting that Horse Trends owed her $230,000.

In November 2002, the Chapter 7 trustee filed a final report, disclosing administrative expenses paid or to be paid, and proposing to pay one priority claim and to distribute the balance of the $63,000 to the unsecured claim holders, including Peoples and Betty Rowley. Ms. Rowley objected to the report. Among other things, she contended that Peoples's claim should be completely disallowed. Later, she filed a formal objection to the proof of claim that Peoples had filed, contending that the June 18,

[3] *See* K.S.A. 84-3-104, -105, -106, -108, -109.

2001, settlement barred Peoples from asserting any such claim against Horse Trends. She and Peoples submitted their dispute for resolution based on stipulated facts. At a hearing in January 2004, a number of documents, including the settlement agreements of May 25, 2000, June 7, 2001, and June 18, 2001, were admitted into evidence. Neither party has indicated any desire to present any other evidence.

DISCUSSION

Under Kansas law, the primary rule in construing a settlement agreement is that, if possible, the Court must determine the parties' mutual intent at the time they made the contract and give effect to that intent.[4] The Court must construe the agreement in light of its language and the circumstances surrounding its making.[5] In the absence of fraud, bad faith, or mutual mistake, neither party may repudiate a settlement agreement.[6] However, a written instrument may be reformed where one side it mistaken about its contents or meaning, and the other side knows of the mistake when the instrument is executed and later, tries to take advantage of it.[7] Such a unilateral mistake can be corrected by reforming the instrument to conform to the parties' true intent.[8] In this case, Peoples

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[4] *Washburn v. Washburn*, 204 Kan. 160, 161 (1969).

[5] *Welborn v. United States*, 736 F.Supp. 1070, 1071 (D.Kan. 1990); *In re Estate of Engels*, 10 Kan. App. 2d 103, 106 (1984).

[6] *In re Estate of Thompson*, 226 Kan. 437, 440 (1979).

[7] *Andres v. Claassen*, 238 Kan. 732, 740-41 (1986).

[8] *Id.*

argues that the language "all secured claims in the bankruptcy court will be considered paid in full" clearly and unambiguously meant that it retained the right to assert an unsecured claim in the Horse Trends bankruptcy. While Ms. Rowley agrees that the settlement is unambiguous, she contends that by marking the notes "paid in full" and returning them to the Rowleys, Peoples gave up any right it might otherwise have had to assert an unsecured claim.

After considering all the circumstances, the Court is convinced that, while Peoples might have thought it was retaining an unsecured claim that it could assert in the Horse Trends bankruptcy case, the words "secured claims" were not sufficiently clear to preserve that right, or to alert the Rowleys that Peoples intended to retain that right. Instead, other language in the settlement and other facets of the surrounding circumstances lead the Court to conclude that Peoples effectively released all its claims against Horse Trends, as well as all the Rowleys. At most, Peoples has shown that it made a unilateral mistake about the meaning of the settlement. Peoples has failed to show, however, that the Rowleys were aware of this mistake or were guilty of other misconduct that would justify reforming the settlement.

Peoples's argument depends on the words "secured claims" having a single, unambiguous meaning. Outside bankruptcy, where this settlement occurred, the Court believes that "secured claim" would usually refer to a claim protected by a lien, without regard to the value of the property subject to the lien. Simply put, outside bankruptcy,

people typically don't talk about a creditor's claim against a debtor as including both a secured claim and an unsecured claim, at least until the creditor forecloses on its collateral and does not recover enough to pay all of its claim.

In the settlement, of course, the phrase was used in a clause referring to the Horse Trends bankruptcy case, so it might be plausible to think the parties used "secured claim" in a specialized bankruptcy sense, assuming there is one. And § 506(a) of the Bankruptcy Code does suggest a potentially-special bankruptcy meaning for "secured claim" because, as relevant here, it says that a creditor's allowed claim that is secured by a lien on property of the bankruptcy estate "is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim." Thus, in bankruptcy, a creditor's claim can be split into "secured" and "unsecured" portions based on the value of the creditor's collateral, and for many purposes, it will be. In fact, the Court believes this is probably the most common way that bankruptcy attorneys think and talk about secured creditors' claims in bankruptcy cases. But this is not the only meaning "secured claim" can have in bankruptcy.

In *Dewsnup v. Timm*, the Supreme Court concluded that § 506(a) was not a definitional section and refused to rely on it as specifying the meaning of the phrase "allowed secured claim" in § 506(d).[9] The Court instead read § 506(d) to refer to a claim

[9]502 U.S. 410, 415-18 (1992).

that: (1) had been allowed; and (2) was secured by a lien with recourse to the underlying collateral.[10] The Court expressly rejected the debtor's suggestion that the phrase referred only to the portion of the creditor's claim determined under § 506(a) to be protected by collateral value.[11] Under the *Dewsnup* approach, all the claims Peoples had against Horse Trends were "secured claims" because the debtor's real property and several items of personal property served as collateral for all of them, even if the property was not worth as much as the total amount of the claims. So, even in bankruptcy, "secured claims" could refer either to the full amount of Peoples's claims against Horse Trends, or to that portion of its claims that equaled the value of the collateral Horse Trends had pledged to it. In light of these different possible meanings for "secured claims," the Court cannot agree with Peoples that those words necessarily referred only to the value of its collateral, and were sufficient to alert the Rowleys that Peoples intended to retain the right to assert an unsecured claim in the Horse Trends bankruptcy. At best, the words suggest the settlement might be ambiguous. Peoples has presented no evidence to show that the Rowleys were aware of the bank's mistaken understanding that "secured claims" could refer only to the value of its liens against the debtor's property, and not to the full amount of its claims without regard to the value of its collateral.

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[10] *Id.*

[11] *Id.*

One facet of the May 2000 settlement exposes another problem with Peoples's argument. In that settlement, Horse Trends gave Peoples a security interest in the one asset, the Construction Judgment, that produced the money to be distributed to creditors in the bankruptcy case. Even though that security interest may have been vulnerable to the bankruptcy trustee's avoidance powers, nothing in the bankruptcy case file indicates that the lien had been formally questioned, much less avoided, or formally abandoned by Peoples, before the Rowleys and Peoples reached their new settlements in June 2001. Peoples has offered no evidence to indicate that it had informally abandoned the lien by then, either. Nothing presented to the Court suggests that in June 2001, Peoples's claim to the proceeds of the Construction Judgment was not still "secured" in the *Dewsnup* sense of that word, or that the Rowleys had any reason to think it was not.

Other aspects of the language of and the circumstances surrounding the June 2001 settlements lead to the conclusion that they should be read to have released all of the claims Peoples had against Horse Trends.

First, the debts that Horse Trends owed Peoples were based on notes, that is, the debtor's promises to pay Peoples money. Under Article 3 of the Kansas UCC, a "person entitled to enforce an instrument, with or without consideration, may discharge the obligation of the party to pay the instrument (1) by an intentional voluntary act, such as surrender of the instrument to the party, . . . or the addition of words to the instrument

indicating discharge. . . ."[12] Peoples marked the Horse Trends notes "paid in full" and returned them to the Rowleys. Because the Rowleys owned and controlled Horse Trends, returning its notes to them probably satisfied the first clause of this provision, and marking the notes "paid in full" certainly satisfied the second clause. Some courts have allowed a creditor to prove that the parties intended for some payment obligation to remain despite marking an instrument "paid" or surrendering it to the obligor,[13] but the Court has already explained why the words "secured claims" — the only proof Peoples has offered — were not clear enough to establish such an intent.

Peoples suggests that the decision in *Coffeyville State Bank v. Lembeck*[14] indicates that marking a note "paid" and returning it to the obligor does not extinguish the debt it represents. The circumstances in *Lembeck* were somewhat similar to those involved here, but no note was marked "paid" and returned to the obligor. Instead, when one of the Lembecks defaulted on a promissory note, the bank sued both of them, and the parties reached a settlement under which the Lembecks gave the bank the personal property that

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[12]K.S.A. 84-3-604(a)(1).

[13]*See, e.g., Columbia Savings v. Zelinger*, 794 P.2d 231, 234-38 (Colo. 1990); *Guaranty Bank & Trust Co. v. Dowling*, 494 A.2d 1216, 1219 (Conn. App. 1985); *Richardson v. First Nat'l Bank*, 660 S.W.2d 678, 679-80 (Ky. App. 1983). The parties have not cited and the Court has not found any Kansas case addressing this question. Decisions applying Kansas law have allowed a mortgage to be enforced when the holder showed it had been mistakenly released, but the debtors who owed the mortgages were not involved in the activities that led to the mistaken releases, so they had reason to know the releases were mistakes. *See Mid-Continent Lodging Assocs., Inc., v. First Nat'l Bank*, 999 F.Supp. 1443, 1447-48 (D.Kan. 1998); *Southern Kansas Farm, Loan and Trust Co. v. Garrity*, 57 Kan. 805 (1897).

[14]227 Kan. 857 (1980).

had secured the note, plus their equity in some real property and a new promissory note in a reduced amount.[15] When the Lembecks later defaulted on the new note, the parties amended their settlement, then the Lembecks defaulted again, and the bank sued and obtained a judgment on the amended settlement, which it ultimately collected.[16] Still later, the bank learned that one of the Lembecks would receive a sizeable inheritance and sued them again on the original note.[17] The Kansas Supreme Court ruled that the bank could have sued on the original note when the Lembecks defaulted on the settlement, but had elected its remedies by obtaining a judgment on the settlement and was estopped to sue on the original note after that.[18] In dicta, the court added a quotation from *Corbin on Contracts* that indicates the original note would have been discharged if the Lembecks had fully performed under the settlement.[19] To the extent the decision has any bearing on this case, it indicates only that Peoples's original claims against the Rowleys and Horse Trends were not discharged until the June 18, 2001, settlement was fully performed. Neither party has suggested that any additional performance remains due under that settlement.

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[15]227 Kan. at 857-59.

[16]*Id*. at 859.

[17]*Id*.

[18]*Id*. at 859-61

[19]*Id*. at 861.

Second, the bankruptcy schedules that Horse Trends filed declared that Peoples was completely secured, and had unsecured claims of "0." Until Peoples filed its proof of claim after settling with the Rowleys, this was the only clear statement in the pleadings that had been filed in the bankruptcy case whether Peoples might have any unsecured claim. Earlier, Horse Trends had included Peoples on the list of creditors holding the twenty largest unsecured claims against it that was filed with its bankruptcy petition, but failed to indicate that any portion of the claim was secured. The Court believes the later-filed schedules superseded this suggestion that Peoples had any unsecured claim. By alleging that Horse Trends had no equity in Peoples's collateral, the stay relief motion that Peoples filed early in the case does hint that Peoples might still have an unsecured claim after liquidating its collateral, but the motion does not affirmatively allege that this will be the case. Consequently, the pleadings in the Horse Trends bankruptcy do not clearly alert the Rowleys that Peoples had an unsecured claim in the case, in addition to its secured claims.

Third, other than the ambiguity of the words "secured claims," the language used in the agreement to describe the notes, mortgages, liens, disputes, causes of action, and liability covered by and released under the June 18, 2001, settlement is as broad and inclusive as seems possible: (1) "all secured claims in the bankruptcy court," and "all mortgages, liens and other encumbrances that Peoples has on any collateral that Horsetrends or the Rowleys have ever pledged to Peoples," used in paragraph 2; (2) "all

outstanding disputes, claims and causes of action," used in paragraph C; and (3) "any and all liability arising out of any act, omission or transaction that has happened or occurred prior to and including the date of this Agreement," used in paragraph 5. While Horse Trends did not directly join in the settlement, it was expressly made a third-party beneficiary of the agreement, and many of the settlement's provisions are clearly intended to affect its rights and property. If any doubt could have existed, the fact that Peoples returned notes that Horse Trends was liable on and released mortgages and liens against Horse Trends's property makes clear that Peoples understood the descriptions quoted above to apply to Horse Trends, as well as to the Rowleys.

Fourth, in June 2001, Peoples already had the right to record the deed making it the owner of the Horse Trends real property, and Peoples always had the obligation to give Horse Trends credit against its debt to the bank for the amount Peoples received in liquidating that property. If Peoples was not giving up any unsecured claim it could have asserted against Horse Trends, what benefit did Horse Trends get from the settlement? As a corporation, Horse Trends was not eligible for a Chapter 7 bankruptcy discharge,[20] and if the settlement left Peoples with the right to assert an unsecured claim in the bankruptcy case, Peoples must also have retained the right to assert any remaining deficiency against Horse Trends after its bankruptcy case was over. Yet, at a hearing in January 2004, Peoples conceded that it could not assert any unsecured claim against

[20] *See* 11 U.S.C.A. § 727(a)(1).

Horse Trends except in the bankruptcy case. The Court sees nothing in the agreement that supports this distinction. If "all secured claims in the bankruptcy court will be considered paid in full" meant that Peoples could still assert an unsecured claim in the bankruptcy case, it must also have meant that Peoples could continue to assert that unsecured claim against Horse Trends after it received the partial payment from the bankruptcy estate. In fact, the lack of a discharge of remaining debts is probably one of the reasons an entity like Horse Trends is unlikely to resume operations after completing a Chapter 7 liquidation.

Fifth, from the materials submitted, the Court does not see how the Rowleys could have known that Peoples intended to retain the right to assert an unsecured claim in the Horse Trends bankruptcy case. "Secured claims" alone was not enough to alert them, and everything else indicated Peoples was agreeing that the money the Rowleys were supposed to pay it would constitute all the payment it was entitled to. Everything else in the agreement indicated that Peoples was completely giving up all its rights against Horse Trends and the Rowleys, and completely ending their creditor-debtor relationships.

CONCLUSION

For these reasons, the Court concludes that Ms. Rowley's objection to the unsecured claim of Peoples Bank must be sustained, and the claim must be fully disallowed.

The foregoing constitutes Findings of Fact and Conclusions of Law under Rule 7052 of the Federal Rules of Bankruptcy Procedure and Rule 52(a) of the Federal Rules of Civil Procedure. A judgment based on this ruling will be entered on a separate document as required by FRBP 9021 and FRCP 58.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that true and correct copies of the above **MEMORANDUM OF DECISION ON OBJECTION TO PEOPLES BANK'S PROOF OF CLAIM** were mailed via regular U.S. mail, postage prepaid, on the 14th day of September, 2004 to the following:

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